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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Access Charge Reform	CC Docket No. 96-262

COMMENTS OF THE INDEPENDENT TELEPHONE & TELECOMMUNICATIONS ALLIANCE

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SUMMARY

The Independent Telephone & Telecommunications Alliance ("ITTA") urges the Commission to reconsider its decision to apply one X-factor to all price cap local exchange carriers ("LECs"). In eliminating the mid-size company data from its calculations, the Commission has set an unrealistically high X-factor which will be difficult for any mid-size LEC to meet. The productivity data of mid-size LECs will inevitably be overwhelmed when combined with data from the much larger telephone companies. Ignoring the unique circumstances of mid-size LECs will jeopardize their ability to earn sufficient revenues to support universal service obligations and prudent investment in their networks. The low-end adjustment mechanism, though necessary to ensure the constitutionality of price cap regulation, will not provide sufficient protection.

Mid-size LECs will be discouraged from electing price cap regulation if they are forced to meet unrealistic levels of productivity. This will force them to suffer the burden of less efficient rate-of-return regulation, which will deprive customers of additional benefits and limit the LECs' ability to compete. Similarly, retroactively applying the new X-factor will deter all LECs from expending the resources needed to improve productivity since any additional profits earned will be taken away the following year.

To ensure that as many carriers and customers as possible benefit from price cap regulation, the Commission should immediately suspend the 6.5 percent X-factor for elective price cap LECs and allow them to revise their tariffs to use the 5.3 percent X-factor without sharing. The Commission should then initiate a rulemaking proceeding seeking comments and data on the productivity of mid-size LECs and establish appropriate X-factors that will give these carriers incentives to elect price cap regulation.

The Commission should not adopt the changes urged by AT&T and the Ad Hoc Telecommunications Users Committee ("Ad Hoc") – who failed even to reference the unique circumstances and needs of mid-size LECs – as they will only make price cap regulation more unmanageable for mid-size LECs. Ad Hoc's price cap model lacks any reliable estimate of the input price differential needed to compute productivity and will lead to wildly inaccurate X-factors. Similarly, AT&T and Ad Hoc provide no support for their claims that a hedonic price adjustment accurately reflects productivity gains by LECs. Finally, as the Commission correctly concluded, there is no reliable method by which to compute a separate interstate productivity factor since the same network elements provide both interstate and intrastate services, and an increase in demand for either service increases the productivity of both.

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THE INDEPENDENT TELEPHONE & TELECOMMUNICATIONS ALLIANCE

The Independent Telephone & Telecommunications Alliance ("ITTA")[1] hereby submits its comments on the petitions for reconsideration filed in the above-captioned docket.[2] For the reasons discussed herein, ITTA requests that the Commission reconsider its decision to apply one X-factor to all local exchange carriers ("LECs") regardless of their size and the characteristics of the areas they serve. Instead, the Commission should immediately suspend application of the existing X-factor for mid-size companies and initiate a proceeding to study productivity capabilities of mid-size LECs. It should then establish appropriate X-factors that allow these LECs to bring the benefits of price cap regulation to their customers.

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[1] The ITTA is an organization of fifteen mid-size telephone companies formed in 1994 to represent the interests of mid-size companies as they are defined in the Telecommunications Act of 1996 -- those companies that serve less than two percent of the Nation's access lines. The companies currently operate in forty-one states and serve over seven million predominantly rural customers.

[2] Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 96-262 (rel. May 21, 1997) ("*Price Cap Order*"). Petitions for reconsideration of this Order were due on July 11, 1997.

I. THE COMMISSION UNLAWFULLY FAILED TO CONSIDER EVIDENCE OF LOWER PRODUCTIVITY FOR MID-SIZE LECS IN SETTING A SINGLE X-FACTOR FOR ALL LECS.

ITTA agrees with Cincinnati Bell Telephone ("CBT") and Citizens Utilities Company ("Citizens") that the Commission made an egregious error in failing to consider productivity evidence for mid-size LECs in crafting the 6.5 percent X-factor.[3] Had the Commission considered such evidence, it could not have rationally concluded that a single 6.5 percent X-factor was reasonable or justifiable for all LECs, and in particular for mid-size LECs. By ignoring crucial productivity evidence of mid-size LECs, the Commission undermined the overall objective of price cap regulation, which is to increase efficiency and productivity to the benefit of both consumers and carriers.

Evidence proffered by CBT and Citizens demonstrates their inability to achieve 6.5 percent productivity growth in recent years, and the extreme implausibility that they will be able to achieve such growth consistently in the future. Consequently, the Commission's adoption of a 6.5 percent X-factor will deter mid-size LECs from electing price cap regulation and impair the financial integrity of mid-sized LECs that already have done so, undermining the Commission's goal of bringing the benefits of price cap regulation to more consumers and carriers.

[3] Petition for Reconsideration of the Cincinnati Bell Telephone Company, CC Docket No. 94-1 at 6 (filed July 11, 1997) ("CBT Petition") (stating "the most egregious of the[] [Commission's] errors is the use of only RBOC data and experience to set an X-Factor that will apply to all price cap LECs (citing *Price Cap Order,* ¶ 135)); Petition for Reconsideration of the Citizens Utilities Company, CC Docket Nos. 94-1, 96-262 at 7 (filed July 11, 1997) ("Citizens Petition") (stating that it was inappropriate for "the Commission [to rely] solely upon historic BOC data in its TFP methodology to arrive at the prescribed 6.5% productivity factor (citing *Price Cap Order,* ¶ 135)).

A. The FCC's refusal to consider evidence of mid-size LEC productivity is arbitrary and capricious.

1. The combination of mid-size and large LEC data unreasonably skews the X-factor far above the productivity level most mid-size LECs can reasonably expect to achieve.

Citizens and CBT correctly point out that the Commission failed to articulate a rational basis for ignoring productivity evidence from mid-size LECs.[4] The only rationale offered by the Commission for ignoring mid-size company data – that USTA's inclusion of productivity data from GTE, SNET, Sprint, and Lincoln in its model only altered the X-factor by 0.1 percent[5] – fails to acknowledge that by their disproportionately greater size, the Bell Operating Companies completely dominated the statistical sample in question concealing the significant differences between the largest price cap companies and the smaller mid-size companies. The largest LECs account for 92 percent of the access lines served by all price cap LECs. The mid-size LECs included in the study (SNET and Aliant) account for less than two percent of the total access lines examined by the study.[6] The 0.1 percent difference in the X-factor thus results from the predominance of the large LECs in the local exchange market and not the similarities among different-size companies, as presumed by the Commission. Inferring from this statistical inevitability that mid-size LECs experience the same productivity as the large LECs is a serious and indefensible error.

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[4] Citizens Petition at 7; CBT Petition at 1.

[5] *Price Cap Order,* ¶ 135. While USTA's model is not representative of all mid-size LECs, the Commission erred in failing to examine specifically the mid-size LEC productivity data included in the USTA model.

[6] CBT Petition at 7.

Moreover, merging mid-size and large company data ignores significant operational differences among companies. As Citizens correctly points out, the vast majority of mid-size LECs lack the market share and economies of scale and scope possessed by the large LECs.[7] Indeed, the disparity in the economic conditions faced by mid-size and large LECs is aptly reflected in the Telecommunications Act of 1996, which specifically permits suspension or modification of certain Section 251 obligations for LECs with fewer than two percent of the Nation's subscriber lines.[8] Clearly, mid-size companies rarely serve the dense urban markets typically served by the largest companies, where a disproportionate number of high-demand, multi-line users are located. Therefore, at the outset, it was irrational for the Commission to contemplate using a model combining large LEC and mid-size LEC data to establish one X-factor for all LECs. When combined data are used to derive only one productivity factor, the result will inevitably reflect the capabilities of larger LECs rather than those of mid-size LECs.[9]

Nor could the Commission mitigate this error by simply examining the existing mid-size company data in the record separately. The USTA model only included data for two mid-sized LECs, SNET and Lincoln (Aliant). It would be patently unreasonable to extrapolate to many other mid-size LECs based on results from these two data points. As the Commission has recognized, mid-size LECs face unique circumstances which may justify a different approach to

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[7] Citizens Petition at 10.

[8] 47 U.S.C. § 251(f)(2).

[9] In the past, the Commission has adopted multiple X-factors to reflect the needs of LECs with different productivity capabilities.

price cap regulation, including a lower productivity factor.[10] The Commission has never acted on this recognition, and certainly did not give special attention to the regulatory concerns of mid-size LECs in crafting the 6.5 percent X-factor. Instead, it ignored important productivity data for these carriers and adopted an X-factor that likely will be unachievable for many mid-size LECs in the near future. As explained below in Section II.A.1, the Commission must consider mid-size LEC productivity data separately from large LEC data in developing X-factors for mid-size carriers.

2. The low-end adjustment mechanism is an inadequate remedy to redress the unlawfully high X-factor.

The low-end adjustment mechanism does not compensate for the unreasonably high 6.5 percent X-factor.[11] As indicated by Citizens, such a mechanism is only prospective in nature.[12] Thus, mid-size price-cap LECs earning a return of less than 10.25 percent would suffer significant losses for up to one year without any form of recoupment. Mid-size LECs, unlike the large LECs, lack the economies of scale and scope to ride out a year of low earnings. As such, the low-end adjustment mechanism is inherently flawed and fails to achieve its own stated end. Thus, it is impractical for the Commission to consider the low-end adjustment mechanism a viable remedy for these carriers.

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[10] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 67867, 6827 (1990) ("1990 Price Cap Order") (stating "A number of . . . issues of special interest to small telephone companies also appear to require further consideration as we move into price cap regulation.")

[11] *See* Section II.B.4, *infra.*

[12] Citizens Petition at 9-10.

In addition, the low-end adjustment mechanism does not provide mid-size LECs with any opportunity to realize a meaningful profit. As structured, this mechanism permits LECs with rates of return less than 10.25 percent to raise their rates the next year to a level that would enable them to earn 10.25 percent. Carriers in such a predicament will have lost significant returns for the preceding year and be forced into a situation in which they have no pricing flexibility.[13] Thus, they will have no ability to realize a meaningful profit.[14] The 6.5 percent X-factor will cause mid-size LECs to lose necessary income without any hope of realizing a gain. Thus, as a policy matter, the low-end adjustment mechanism is an impractical solution to the problems that would result from application of the 6.5 percent X-factor.

B. The 6.5 percent X-factor is inconsistent with the universal service mandate of Section 254(e).

ITTA agrees with Citizens that application of the 6.5 percent X-factor would make it extremely difficult for mid-size LECs to satisfy their universal service obligations.[15] Under Section 254(e), mid-size LECs eligible to receive universal service support must invest these funds in upgrading facilities and services.[16] As illustrated in the productivity data submitted by

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[13] Where a LEC is forced to use the low-end adjustment mechanism, it will have to raise its rates to the maximum allowed by this mechanism to recoup its losses and attempt to make a small profit. Accordingly, these carriers will lack any pricing flexibility to compete with other carriers.

[14] *See 1990 Price Cap Order* at 6804 (stating "[W]e also reject arguments that we should never allow adjustments for low earnings. . . . Failure to include any adjustment for such circumstances could harm customers as well as stockholders of such a LEC. Unusually low earnings over a prolonged period could threaten the LEC's ability to raise the capital necessary to provide modern, efficient services to customers.")

[15] Citizens Petition at 11-12.

[16] 47 U.S.C. § 254(e).

Citizens, CBT, and other mid-size LECs, these carriers will have a difficult, if not impossible, time attaining a 6.5 percent productivity level in the near future.[17] Further, when the additional profit reductions these carriers will face due to access reform are taken into account, it is obvious that mid-size LECs will not be able to cover their costs, make obligatory investments in equipment and upgrades, or realize a reasonable profit with application of the 6.5 percent X-factor. Accordingly, retention of the 6.5 percent X-factor for mid-size LECs will jeopardize the continued ability of these carriers to satisfy their obligations under the 1996 Act.

C. The FCC should suspend the new X-factor for elective price cap LECs and initiate a proceeding on the productivity gains of mid-size LECs.

The Commission has acknowledged concerns that mid-sized LECs operate in a different environment and face different opportunities for productivity growth than larger LECs.[18] By choosing to ignore these differences in establishing the X-factor – differences which were reflected to some extent in the USTA model – the Commission acted in direct contravention of this determination and created an X-factor wholly unrelated to the experiences of mid-size LECs.

In adopting a single, fixed X-factor, the Commission stated,

> [T]he record contains no convincing proposals that would allow us readily to identify any characteristics by which we could assign individual X-Factors to different price cap carriers so that there could be multiple "no-sharing" X-Factors .... [M]ultiple X-Factors are not necessary to be fair to LECs with productivity growth less than the industry average because the low-end adjustment mechanism provides adequate protection for those LECs.... A single X-Factor plan is likely to improve economic efficiency ... [and] will significantly simplify our rules.[19]

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[17] Citizens Petition, Attachment 2, at 5-13; CBT Petition at 6-8, Appendix.

[18] *1990 Price Cap Order* at 6827 (stating "[W]e will continue to examine the range of issues affecting small telephone companies... to ensure that desirable reforms are applied ... with sensitivity to their special circumstances.")

[19] *Price Cap Order,* ¶¶ 158-160.

The data supplied by mid-size LECs, however, demonstrates that these carriers have characteristics distinguishable from large LECs, justifying establishing multiple X-factors. Thus, in refusing to examine mid-size carriers' data, the Commission ignored their unique needs. While a single X-factor may simplify the Commission's rules, it certainly will increase mid-size LECs' difficulty in becoming more efficient and productive. Further, as discussed above, the low-end adjustment mechanism will not suffice as a remedy for low earnings as it does not afford mid-size LECs the opportunity to recoup losses or realize a meaningful profit.

Accordingly, the Commission should acknowledge its error in failing to review mid-size LEC productivity data and immediately suspend operation of the new 6.5 percent productivity factor rules for elective price cap LECs. In the interim, mid-size price cap LECs should be permitted to revise their tariffs pursuant to streamlined tariff rules and use the 5.3 percent productivity factor without sharing.

While this transition plan is in place, the Commission should adopt a notice of proposed rulemaking seeking data and comments on the productivity gains that can reasonably be expected from elective price cap LECs. The Commission should focus on the size, customer demographics, largely rural nature, revenue, cost structure, and other pertinent factors affecting mid-size LEC productivity. Based on the results of the data request, the Commission should consider creating several productivity factors representative of the diversity of price cap LECs, as recommended by CBT.[20] Under this approach, one X-factor would apply to a mid-size LEC with

[20] CBT Petition at 8.

a mid-size geographic service area, mid-size customer base, and evidenced low productivity growth while another would apply to a large LEC with a large geographic service area, significant customer base, and documented high productivity growth.

Importantly, price cap LECs would not be free to choose an X-factor. Rather, each X-factor established by the Commission would apply to price cap LECs exhibiting a particular set of characteristics, such as size and customer base. Under this approach, price cap LECs, particularly mid-size LECs, would be subject to an X-factor based on the attributes of the customers and areas they serve. This modified price cap plan would be implemented as soon as possible but no later than the introduction of the universal service high cost mechanism for rural LECs.

The Commission adopted price cap regulation "because it found that rate-of-return regulation did not create adequate efficiency incentives for incumbent LECs, and required administratively burdensome cost allocation rules to enforce."[21] The purpose of price cap regulation is "to ensure that '[b]oth carriers and customers will be better off'"[22] through expanded efficiencies and lower costs. However, as the Commission noted when it first considered price cap regulation, medium-sized LECs have different needs which must be considered.[23] To succeed in its goal of encouraging additional LECs to elect price cap regulation, the Commission must give mid-size LECs the opportunity to earn a reasonable profit. ITTA's proposal preserves this opportunity and, therefore, advances the Commission's ultimate goal.

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[21] *Price Cap Order,* ¶ 3.

[22] *Price Cap Order,* ¶ 2 (quoting *1990 Price Cap Order* at 6790).

[23] *1990 Price Cap Order* at 6827.

II. THE FCC SHOULD REJECT ARGUMENTS THAT THE X-FACTOR BE RAISED FURTHER.

The Commission correctly rejected AT&T's, the Ad Hoc Telecommunications Users Committee's ("Ad Hoc"), and other petitioners' arguments adopted in the *Order* that the X-factor should be increased.[24] As discussed below, these parties present no evidence that would justify a higher X-factor for any class of LECs. They certainly provide no support for a higher X-factor for mid-size LECs, since they fail to even reference the unique circumstances of mid-size LECs or their slower productivity growth. As such, any suggestion that an increased X-factor is warranted for mid-size LECs is patently insupportable.

As documented above, the Commission neither established nor considered a complete evidentiary record prior to adopting the 6.5 percent X-factor. Because of the selectivity of the data considered, the adopted X-factor will already prove to be unreasonably high for many mid-size LECs. Accordingly, any increase in this factor would surely be impossible for these carriers.

A. The 6.5 percent X-factor is already unjustifiably high for mid-size LECs.

In order to adopt X-factors which accurately estimate possible productivity gains, the Commission must review *all* available record evidence on LEC productivity. The Commission also must recognize that productivity will decline in response to competition and decreased universal service funding and that LEC profitability is an inappropriate basis for determining productivity. Importantly, the Commission should not utilize either Ad Hoc's unsubstantiated

[24] Petition of AT&T Corp. for Partial Reconsideration of the Commission's X-Factor Order, CC Docket No. 94-1, CC Docket No. 96-262 at 6 (filed July 11, 1997) ("AT&T Petition"); Petition for Reconsideration on Behalf of Ad Hoc Telecommunications Users Committee, CC Docket Nos. 94-1, 96-262 at 2 (filed July 11, 1997) ("Ad Hoc Petition").

productivity model or a hedonic price increase because these do not reflect realistic productivity increases.

1. The FCC should rely on the best available record evidence in establishing the X-factor.

One of the Commission's primary goals in establishing price cap regulation was to encourage growth in productivity. Under this form of regulation, LECs that increase their productivity earn higher profits, and consumers benefit from the productivity growth via reduced rates. However, under the Commission's revised price cap plan, consumers will benefit in the short term via a reduction in rates, but will suffer in the long run because LECs, particularly mid-size LECs, will have insufficient revenues to upgrade their networks and meet universal service obligations.

As explained above, the Commission's decision to adopt a 6.5 percent X-factor was not based on a careful analysis of the productivity growth of LECs generally, as claimed in the *Price Cap Order*,[25] but rather on an examination of only one class of LECs – Bell Operating Companies. In establishing the X-factor, the Commission should have relied on the best available record evidence. Such evidence necessarily includes the most recent experience of mid-size LECs under price cap regulation and their estimates for future productivity growth. As the data supplied by Citizens, CBT, and other LECs demonstrate, productivity growth for rural and mid-size LECs was well below 6.5 percent from 1990 to 1995, and estimates for future growth do not approach 6.5 percent.[26] It was arbitrary for the Commission to exclude such

[25] *Price Cap Order*, ¶ 2.

[26] Citizens Petition, Attachment 2, at 5-13; CBT Petition at 6-8.

compelling data from its calculations and yet establish a productivity factor for the very LECs whose data were ignored. At a minimum, the Commission is obligated to adhere to its stated goal of fashioning an X-factor based on achievable productivity. For mid-size LECs, this goal can only be accomplished via consideration of their specific price cap experience, most notably their productivity growth in recent years.

2. The FCC ignored productivity declines expected from increased competition, notwithstanding its expectation that its policies would substantially increase competition in the short run.

The Commission has stated that it expects price cap regulation to increase competition substantially in the short term.[27] Nonetheless, it established an X-factor to be applied year after year without considering the negative impact increased competition will have on productivity growth. Common sense and experience both show that increased competition will reduce, not increase, productivity growth. Demand for ILEC services will decrease as customers switch to competitors, but ILECs will experience little or no reduction in fixed costs.

The Commission's *Access Reform Order* likely will exacerbate these competitive losses and, therefore, further depress productivity. Unlike ILECs, competitive LECs ("CLECs") do not have to charge subscriber line charges and primary interexchange carrier charges. Accordingly, they can offer lower rates for the very same services offered by ILECs. With such an unfair competitive advantage, CLECs increasingly will erode ILECs' market share and ability to attract new consumers. Lower outputs combined with steady inputs inevitably means reduced productivity growth.

[27] *Price Cap Order*, ¶ 4.

The Commission's refusal to review the X-factor for three years compounds the error by failing to take into account known changes to productivity. It is nonsensical to establish an X-factor which will remain static for three years in an environment constantly changing in light of competition and regulatory reform. Even if a 6.5 percent X-factor could be justified at present – which, based on the record evidence for mid-size carriers, it unquestionably cannot – it likely would not be accurate one year from now and assuredly will not be so in three years. A set productivity factor will undermine the Commission's overarching goals for price cap regulation and universal service because significantly diminished revenues for LECs will reduce efficiency, capital investment, and productivity.

3. The FCC's decision to consider forward-looking economic costs and inflated revenue benchmarks in computing universal service payments will lead to rate increases and lower productivity growth.

In adopting the 6.5 percent X-factor, the Commission failed to examine the effect on productivity growth of using forward-looking economic costs and inflated revenue benchmarks in computing universal service payments. The level of support LECs will receive for universal service under the Commission's approach will be inadequate to cover their true costs of providing such service. This is so because the Commission has decided to consider only hypothetical forward-looking costs in computing universal service payments, which significantly understate the actual forward-looking costs of providing such service using existing network facilities.

Moreover, instead of considering only revenues from services included in the universal service package, the Commission has decided to include revenues from other services when calculating the support amount a LEC will receive. The net result is that the calculated support for the provision of universal service will be insufficient to offset the actual costs of providing this service. Accordingly, to offset these costs, LECs will be forced either to increase their rates (where permitted) or to scale back investment. In either case, demand for LEC services will decrease, in turn driving a reduction in productivity. The Commission must therefore reexamine its 6.5 percent productivity factor in light of predictable slower productivity growth due to insufficient universal service support.

B. The relief sought by AT&T and Ad Hoc would exacerbate the problems faced by mid-size LECs.

1. Contrary to AT&T's claims, LEC profitability is irrelevant to determining the correct X-factor.

AT&T suggests that the Commission should apply the new X-factor retroactively to 1995, based on the fact that price cap LECs on average have earned returns of 14.8 percent.[28] ITTA disagrees. Calculation of the X-factor should be based on demonstrated levels of achievable productivity, not profitability.

The overriding incentive for electing price cap regulation is the potential to earn higher profits. Increased profitability thus indicates that price cap regulation is working. Profitability should not be used as a basis for either calculating the X-factor or applying it retroactively because doing so penalizes the LECs for responding to the incentives created by price cap regulation and enervates any future impetus to decrease costs and increase efficiency. Moreover, as explained in Section III below, retroactive application of an increased X-factor discourages mid-size LECs from electing price cap regulation. The Commission, therefore, should not base any X-factor decisions on past profitability.

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[28] AT&T Petition at 18-20.

2. The FCC correctly rejected Ad Hoc's price cap model because it is based on unsubstantiated assumptions.

The Commission correctly rejected Ad Hoc's unsubstantiated model in determining the X-factor.[29] The software employed by Ad Hoc to calculate its estimates was inaccessible to Commission staff, making it overly burdensome for the Commission to validate the accuracy of the results. In addition, Ad Hoc's input price index exhibited erratic fluctuations, thereby rendering its estimates suspect. The Commission also properly noted that Ad Hoc's model lacked any reliable estimate of the input price differential needed to compute productivity.[30] Since Ad Hoc's petition presents no new arguments justifying reconsideration of its model, the Commission should decline to reexamine its initial decision.

3. A hedonic price adjustment to capital asset indices would arbitrarily inflate the X-factor.

The Commission correctly determined that its current record contains no support for including a hedonic adjustment in the total factor productivity calculation. Despite Ad Hoc's arguments that a hedonic price adjustment is necessary to prevent overstated input price growth,[31] it has not produced evidence that its proposed adjustment will accurately reflect technological advancements in quality or capacity. Moreover, there is no evidence that recent technological advancements have occurred at any greater rate than in the past or that these advancements have not been accurately reflected in past productivity increases, which ITTA believes are the best indicator of future performance. Without documented evidence that a

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[29] *Price Cap Order,* ¶ 38.

[30] *Price Cap Order,* ¶ 38.

[31] Ad Hoc Petition, Declaration of Patricia D. Kravtin, at 14.

specific hedonic adjustment will actually measure the effects of technological improvement, it would be arbitrary and capricious for the Commission to include such an adjustment in its calculation of the X-factor.

4. The Commission was correct in rejecting IXC arguments that only interstate operations be used to predict productivity.

Although some IXCs urge the Commission to rely only on interstate data in determining productivity,[32] an accurate assessment of productivity cannot be calculated without considering total company operations. Calculation of a separate interstate productivity factor will not give a true productivity measure because it is confined to particular inputs and outputs. In order to be accurate, a productivity offset must include the entire range of factors that affect the cost of production and must measure changes in overall efficiency.

Trying to separate inter- and intrastate production will, by definition, lead to artificial results since there is no economically meaningful way of separating the input units that provide both services. Loops, switches, ports, and other LEC equipment are common facilities providing both interstate and intrastate services. The fact that there may be higher demand for interstate access services does not affect this basic truth. Faster growth in usage leads to faster expansion or replacement of switches and trunks that produce both intra- and interstate services. Therefore, more rapid growth in either intra- or interstate usage leads to greater productivity for both types of services, reinforcing that the productivity factor must be calculated using total company production.

[32] *See, e.g.*, AT&T Petition at 3-12.

5. Retaining the low-end adjustment factor is necessary to assure the constitutionality of price cap regulation.

When the Commission adopted price cap regulation, it determined that the new plan must present both "the opportunity for gain if efficiencies are realized" and "the risk of reduced earnings if the carrier fails to reduce costs and become more efficient."[33] However, the Commission included in the plan a low-end adjustment mechanism, which prevents LEC earnings from falling below 10.25 percent:

> Unusually low earnings may be attributable to an error in the productivity factor, the application of an industry-wide factor to a particular LEC, or unforeseen circumstances in a particular area of the country. Failure to include any adjustment for such circumstances could harm customers as well as stockholders of such a LEC. Unusually low earnings over a prolonged period could threaten the LEC's ability to raise the capital necessary to provide modern, efficient services to customers.
>
> . . .
>
> More importantly, the lower end adjustment factor protects the goals of universal and quality service in the Communications Act.[34]

Thus, the Commission itself has acknowledged that a backstop is necessary to ensure that LECs have the opportunity to earn a reasonable return on their capital. Furthermore, the low-end adjustment mechanism fails to achieve its own stated goal, as explained in Section I.A.2.

AT&T argues that the Commission should abolish the low-end adjustment mechanism because it undermines LEC efficiency incentives.[35] AT&T misunderstands the use of this mechanism. First, AT&T states that the low-end adjustment mechanism protects inefficient

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[33] *1990 Price Cap Order* at 6806-6807.

[34] *1990 Price Cap Order* at 6804.

[35] AT&T Comments at 12-16.

LECs. AT&T fails to note, however, that the 10.25 percent allowed under this mechanism is well below the rate of return needed both to guarantee sufficient investment in the LEC network and to provide a reasonable profit to investors, making the low-end adjustment only a last resort.

Second, AT&T argues that, since the Commission has discontinued the sharing requirements, it is somehow asymmetrical to maintain the low-end adjustment. The low-end adjustment mechanism is completely unrelated to the sharing requirements. Courts have consistently found that the Takings Clause of the Constitution requires that utilities must not be limited to a charge for their property serving the public which is so unjust as to be confiscatory.[36] Whether a taking has occurred depends on whether the utility had an opportunity to earn a fair return on its prudent investment.[37] The low-end adjustment mechanism serves specifically to forestall a taking – it prevents price caps from causing such low LEC earnings that the LEC would be unable to attain a reasonable return on its capital. Therefore, the Commission was correct to maintain the low-end adjustment mechanism to ensure the constitutionality of price cap regulation.

III. RETROACTIVELY APPLYING THE NEW X-FACTOR UNDERMINES INCENTIVES FOR MID-SIZE LECS TO ELECT PRICE CAP REGULATION.

The Commission has consistently encouraged LECs to take advantage of price cap regulation. At the same time, it has recognized,[38] just as Congress did in Section 251(f)(2) of the 1996 Act, that medium-sized LECs have different needs than larger LECs and that it should

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[36] *See Federal Power Comm. v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942).

[37] *Id.* at 602.

[38] *1990 Price Cap Order* at 6827.

reduce regulatory burdens on mid-size LECs while increasing their flexibility and efficiency.[39] Indeed, because of the special circumstances mid-size LECs face, the Commission stated that these companies should not elect price cap regulation until further proceedings were completed if it would cause them unreasonable difficulties.[40] However, the Commission has never conducted these further proceedings. Thus, mid-size companies deciding whether to elect price cap regulation face the same constraints and productivity expectations as larger LECs.

To survive in today's increasingly competitive market, mid-size LECs need the pricing flexibility that accompanies price cap regulation. Instead of encouraging them to take advantage of this opportunity, however, the Commission has announced that it will apply the untenable 6.5 percent X-factor retroactively, as if it were in effect during the 1996 annual access period. Such action undermines any incentives for mid-size LECs to choose to participate in price cap regulation. Moreover, companies that have already elected price cap regulation, or are required to participate, will have no incentive to be more efficient if any extra profits will be revoked the following year. To encourage mid-size LECs to elect price cap regulation, the Commission must permit them to retain revenues achieved using whatever X-factor is in place in any particular period, rather than deciding in retrospect that those earnings were too high.

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[39] *1990 Price Cap Order* at 6827.

[40] *1990 Price Cap Order* at 6852 n.399.

IV. CONCLUSION

When the Commission first adopted price cap regulation, it recognized that mid-sized LECs operate under "special circumstances," which differ from larger LECs and require separate consideration. Despite its commitment to do so, the Commission has failed to carefully examine these issues. All LECs, including mid-size carriers, can benefit from the flexibility allowed by price cap regulation, and this ability to adjust to changing market conditions is becoming more crucial with the advent of competition. For the foregoing reasons, ITTA urges the Commission to do a complete evaluation of mid-size LEC productivity data and adopt X-factors which will give mid-size LECs a meaningful opportunity to participate in price cap regulation. In the interim, the Commission should suspend application of the 6.5 percent X-factor to elective price cap LECs and allow these LECs to file tariffs using the 5.3 percent X-factor without sharing.